

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

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| <i>California Independent System</i>         | ) | <b>Docket No. ER02-1656-015</b> |
| <i>Operator Corporation</i>                  | ) |                                 |
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|  | ) |                                 |
| <i>San Diego Gas &amp; Electric Company</i>  | ) | <b>Docket No. EL01-68-028</b>   |
|  | ) |                                 |
| <i>v.</i>                                    | ) |                                 |
|  | ) |                                 |
| <i>Sellers of Energy and Ancillary</i>       | ) |                                 |
| <i>Services Into Markets Operated by the</i> | ) |                                 |
| <i>California Independent System</i>         | ) |                                 |
| <i>Operator and the California Power</i>     | ) |                                 |
| <i>Exchange</i>                              | ) |                                 |

**REPLY COMMENTS OF THE  
CALIFORNIA ENERGY RESOURCES SCHEDULING DIVISION  
OF THE CALIFORNIA DEPARTMENT OF WATER RESOURCES**

Pursuant to Rule 213(d)(2)(ii) of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (“FERC,” “Commission”), 18 C.F.R. § 385.213(d)(2)(ii), the California Energy Resources Scheduling Division of the California Department of Water Resources (“CERS”) hereby submits its reply comments to the comments filed by other parties regarding the California Independent System Operator’s (“CAISO”) Amendment to Comprehensive Market Design Proposal (“Amended MD02 Proposal”).

**I. Introduction**

The comments and protests addressing the CAISO’s Amended MD02 Proposal overwhelmingly reflect the perspective that the Commission should not rush to approve a

proposal that is both flawed and incomplete. In its Comments filed with the Commission on August 27, 2003, CERS explained that the proposed LMP regime will radically alter the existing short-term power market from the zonal system, under which the State Contracts were executed, to a nodal-based platform. Because the nodal system will expose the retail customers of the investor-owned utilities (“IOUs”) to congestion costs that cannot be hedged, the proposed market redesign should not be implemented prior to a satisfactory resolution of potentially severe impacts on the State Contracts.<sup>1</sup> CERS agreed with CAISO that issues related to the long-term contracts must be resolved “prior to implementing LMP.”<sup>2</sup>

CERS concurs with the many parties that strongly urged the Commission not to approve the Amended MD02 Proposal without significant modifications. CERS particularly supports the concerns expressed by other parties that preservation of the State Contracts and other appropriate measures must be taken in order to encourage investment in new transmission and generation and effective demand response, because Locational Marginal Pricing (“LMP”) alone will not serve this function. CERS also supports the comments of other parties, including the California Public Utilities Commission (“CPUC”), advocating the allocation of Congestion Revenue Rights (“CRRs”) on the basis of physical need. CERS therefore submits the comments below in order to emphasize the following principles:

1. Approval and implementation of LMP must be conditioned upon preservation of the value of existing sales contracts, most particularly the

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<sup>1</sup> CERS Comments, p. 3.

<sup>2</sup> *Id.* at 4, 14 (quoting CAISO Transmittal Letter, p. 20).

State Contracts which, as the Commission has recognized, serve a necessary stabilizing function in the California market.

2. Prior to implementation of MD02, other important matters must be completed, including finalizing the CAISO's internal CRR study, resolving cost allocation and other issues related to the CAISO's proposed procedure for honoring Existing Transmission Contracts ("ETCs"), and identifying and aligning the market and scheduling rules that best accommodate both pre-existing and going-forward bilateral sales that occur outside of the CAISO's markets.
3. In order to avoid the potentially destabilizing consequences of introducing LMP into the stressed California market, a transition period must precede full implementation of LMP.
4. The CAISO should not commit funds to the development and implementation of software and systems that cannot later be modified to accommodate unresolved issues, including seams.
5. Because the CAISO's stakeholder process has not adequately addressed stakeholder concerns, the CAISO must develop a clear set of definitive guidelines and rules for a reformed stakeholder process, in conjunction with and subject to consensus among the affected stakeholders.

## **II. The Amended MD02 Proposal Requires Modification in Order to Preserve the Benefits of the State Contracts and other Similarly-Situated System Sales Contracts.**

Pacific Gas & Electric Company ("PG&E") confirms that the State Contracts are "one of the major elements that has stabilized the market and limited the ability for real time gaming and exercise of market power."<sup>3</sup> PG&E further confirms the need for "the CAISO to resolve the issues in a satisfactory way before proceeding with the implementation of a new market design that could have negative impacts on CERS contracts."<sup>4</sup> While the need for accommodating the State Contracts in any new market design is clear, the form that resolution may take is still under active discussion. CERS

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<sup>3</sup> Comments of Pacific Gas & Electric, p. 9.

<sup>4</sup> *Id.*

remains hopeful that a workable accommodation will be realized.<sup>5</sup> As reflected in PG&E's comments, however, LMP cannot be implemented until such a resolution is finalized.

PG&E and CERS are not alone in their recognition that the proposed LMP-based congestion management system is incompatible with the existing State Contracts. The comments of the Northern California Power Agency ("NCPA") echo CERS's concern that the terms of some of the State Contracts may render them unhedgeable under the CAISO's Amended MD02 Proposal. CERS concurs with NCPA that, under the CAISO's Amended MD02 Proposal, resources currently available through the State Contracts where sellers have discretion as to delivery points "may allow for gaming or windfall profits solely due to the proposed change in market structure."<sup>6</sup> NCPA further cites comments made by representatives from the PJM Interconnection, New York Independent System Operator ("NYISO") and Midwest Independent System Operator ("MISO") at a CAISO hosted meeting on LMP and CRRs on August 25, 2003. According to NCPA, "the representatives from these areas where LMP is operational (or soon will be) were unanimous that system sales contracts (where specific resources are not identified) of this type could not be accommodated in a CRR system, which requires the identification of sources and sinks."<sup>7</sup> NCPA further asserts that "[f]ailure to address this issue could have broad impacts, but resolving the issue at the expense of everyone else would be just as serious an error."<sup>8</sup>

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<sup>5</sup> See Comments of CERS, p. 12-14.

<sup>6</sup> Protest and Comments of the Northern California Power Agency, p. 8.

<sup>7</sup> *Id.* at p. 23.

<sup>8</sup> *Id.* at p. 8.

While CERS is primarily concerned with preserving the value and system-wide benefits of the State Contracts, CERS agrees with NCPA and others that the new market design should not compromise the bargained-for benefits of any bilateral contract.

**Indeed, CERS believes that preserving the bargained-for benefits of all existing bilateral contracts should be the Commission's top priority.** If not, market participants will get the wrong signal, and will be discouraged from entering into long-term contracts.

CERS is not seeking preferential treatment, but it is important to understand the pivotal role that the State Contracts have played and continue to play in stabilizing the California electricity market, and to ensure that this stabilizing function of the contracts continues unimpeded by sweeping, untested changes in the market rules. The State Contracts represent a deliberate policy to secure construction of physical assets, and as such provide the bedrock for future market stability and reliability. Bilateral contracts are a crucial vehicle for incenting investment in needed generation and associated transmission upgrades, and in limiting the volatility of short-term markets. The Commission has specifically identified long term contracts as the key element of the wholesale market design going forward throughout the country.<sup>9</sup> As explained in CERS's opening Comments, the State Contracts not only played a key role in stabilizing the out-of-control California energy market, they also provided the revenue certainty

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<sup>9</sup> E.g., *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design*, Docket No. RM01-12-000, Notice of Proposed Rulemaking at P 228 (stating that standard market design is "premised on the use of bilateral contracts. While LSEs may purchase energy in the spot markets, these purchases should constitute a small percentage of their actual purchases.").

needed by generators to finance the construction of new power plants. In return for paying a premium to remove substantial volumes of energy from the volatile spot market, the ratepayers are effectively hedged against future market instabilities and price volatilities. CERS therefore is extremely concerned that the value of that hedge be preserved and that California ratepayers receive the benefits of the State Contracts without incurring additional costs.<sup>10</sup>

The State Contracts are unique due to the circumstances of their inception and their impact on the market. The State Contracts were the Commission's chosen remedy to provide reliable energy to the customers of the California IOUs.<sup>11</sup> Through the State Contracts, sufficient energy was removed from the dysfunctional and costly California spot market to stabilize the market. The forty-six remaining State Contracts continue to play a major role in stabilizing the current market. As discussed in CERS's opening Comments, approximately 6,000 MW of the State Contracts have been determined to be at risk in an LMP-based settlement system. Unless the benefits of the State Contracts are preserved, those 6,000 MW will expose the retail customers of the IOUs to congestion costs that cannot be hedged and will allow the sellers to reap one-sided net settlement windfalls in the form of paper counter-flow payments. 6,000 MW is roughly 15 percent of the CAISO's peak load, or as noted by Metropolitan Water District in their comments, equivalent to that needed to serve the entire load of one of the three IOUs.<sup>12</sup> **The magnitude of the energy supply secured by the State Contracts and the resulting**

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<sup>10</sup> See Comments of CERS, pp. 6-7.

<sup>11</sup> *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services*, 93 FERC ¶ 61,294 at 61,996 (2000).

<sup>12</sup> Protest of the Metropolitan Water District of Southern California, p. 5.

**potential adverse impacts under an LMP based settlement system render the preservation of the State Contracts a critical matter that must be addressed and accommodated prior to the implementation of LMP.**

### **III. Without an Adequate Transition Period the CAISO Risks Repeating Past Mistakes.**

The City of Redding observed that the CAISO seems blind to the need for a transition period.<sup>13</sup> CERS agrees with Redding's suggestion that the Commission direct the CAISO to work with, not around, Market Participants to develop a transition plan that recognizes the legacy of the positive elements of existing markets while moving toward greater market choice in the future.<sup>14</sup> The Commission should recognize that California is still very much in a transition phase complicated not only by the terms of existing power contracts including the State Contracts, but also by the well-identified weaknesses in the State's transmission grid. **Implementing LMP without accommodating the terms of the State Contracts, or before these weaknesses in the grid can be fixed, will result in further exploitation of the California ratepayers.** Not only must the Commission condition implementation of LMP upon prior resolution of the State Contracts issue, but the Commission must also ensure that implementation of the new market, once commenced, includes an adequate transition period.

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<sup>13</sup> Protest of the City of Redding, p. 12.

<sup>14</sup> *Id.*

#### **IV. Market Design Should Not Be Dictated by Software Constraints.**

CERS agrees with the concern expressed by a number of parties that by committing to purchase and implement the software and system designs necessary for the Amended MD02 Proposal, the CAISO will lock itself and market participants into an incomplete, yet inflexible market design. As NCPA explained, once the CAISO is permitted to spend money to design and implement software related to LMP for congestion management, the resulting software product may be difficult or virtually impossible to modify or change even though the Amended MD02 Proposal lacks specific tariff language and details remain to be developed.<sup>15</sup> Similarly, SMUD cautions the Commission that any approval given for funds and software design at this stage will place into motion the inevitable implementation of the subsequent market designs for which the software platform will be designed. Stated another way, “the function of any subsequent and undeveloped elements of MD02 will follow the function of the software platform and not the form of proper market design.”<sup>16</sup> CERS concurs with the principle that software design should not drive market development.

CERS also fears that premature commitment to an inflexible software platform will negate the opportunity for reasoned resolution of current and future unresolved issues. CERS agrees with SMUD that “[u]nresolved and thorny issues such as CRR design and allocation will no longer be decided by reasoned forums; rather, such issues will be decided based on the “software platform.”<sup>17</sup> Moreover, CERS notes that in

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<sup>15</sup> Protest and Comments of NCPA, p. 2.

<sup>16</sup> Motion to Intervene, Reject and Protest of the Sacramento Municipal Utility District, p. 10

<sup>17</sup> *Id.*



addition to the unresolved issues with the CAISO Amended MD02 Proposal, critical seams issues still need to be addressed by neighboring control areas.<sup>18</sup>

CERS also takes note of the CAISO's inability over the last four years to accommodate existing transmission contract (ETC) rights within its ETC scheduling software platform as a relevant precedent. In its August 27, 2003 opening Comments, CERS noted that it supports CAISO's investment in acquiring LMP computation capability and publishing LMP prices, *if* a zonal pricing mechanism for settlement purposes were retained in the interim.<sup>19</sup> CERS believes that the CAISO should proceed with limited procurement and testing of a system simulation software tool that will utilize a network, rather than a radial representation of the grid, for congestion management, security constrained dispatching, and for calculating LMPs. This would represent a significant improvement over the current CAISO system. The LMPs from this software could be used to calculate more accurate zonal prices. These LMPs should not, however, be used for the purpose of settlements or congestion management on a nodal basis until all market design issues are resolved. **Thus, any approved software and system design must be able to accommodate resolution of the unresolved items.** We agree with SMUD that given the opportunity, market participants will capitalize on software inefficiencies for their financial benefit. California's bitter experience of 2000 –2001 attests to the reality of this concern.

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<sup>18</sup> CERS supports the comments of U.S. RTO West Utilities urging the Commission to require the CAISO to implement software and systems that are modular, open and flexible to accommodate resolution of seams issues. Comments of U.S. RTO West Filing Utilities, p. 4.

<sup>19</sup> Comments of CERS, p. 15.

**V. CRRs Should Be Allocated on the Basis of Physical Need Only.**

In its comments on CRR allocation and configuration, the CPUC states that “the purpose of CRRs is to hedge congestion costs for physical energy deliveries, and that CRRs are not principally investment opportunities.”<sup>20</sup> CERS agrees with the CPUC that CRRs should **not** be offered, to the extent available, to all qualified bidders through an auction process, and agrees that CRRs should only be made available to bona fide market participants engaged in the physical delivery of energy to customers. CRRs should not be allowed to become another tool used to manipulate the market and jeopardize reliability for the sake of maximizing profits.

**VI. CAISO’s Proposed Treatment of Transmission Losses Could Add Significant Costs to the State Contracts and Jeopardize the Development of Remotely Located Renewable Energy Resources.**

CERS shares the concerns of parties, including FPL Energy and the American Wind Association, that criticize the CAISO’s proposed methodology for calculating, collecting and disbursing the full marginal loss component in LMP prices. FPL states that CAISO’s proposed treatment of losses “is flawed and adds inappropriate costs to the CAISO energy markets.”<sup>21</sup> CERS concurs, but needs more information to determine the impact of losses on the State Contracts. The CAISO has promised, but not yet provided, the data that will allow stakeholders to more accurately assess the impact of CAISO’s proposal. Additionally, because many of the State’s renewable energy resources such as wind, geothermal and biomass facilities are located in remote areas, CAISO’s proposed

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<sup>20</sup> Comments of the California Public Utilities Commission, p. 13.

<sup>21</sup> Protest of FPL Energy, LLC and the American Wind Energy Association, p. 2.

treatment of transmission losses could negatively impact the future development of these resources.

## **VII. LMP Will Not Provide Incentives for the Construction of Transmission and Generation or the Development of Effective Demand Response Programs.**

Other parties stressed that LMP will not encourage investment in transmission and generation infrastructure or effective demand response programs. As stated by the Bay Area Transmission Group, “[c]oordinated planning is required to ensure that critical transmission and generation infrastructure improvements are realized.”<sup>22</sup> Adequate transmission, generation, and an effective demand response program are the essential elements of a competitive market.

For the reasons discussed in its opening Comments, CERS fully agrees with these points. All market designs are subject to flaws that become painfully obvious and costly to ratepayers when the electrical system is stressed due to inadequate infrastructure. CERS agrees with NCPA that “LMP is a tool for congestion *management*, rather than congestion relief,” and LMP will “do nothing to encourage the building of transmission in the first place, which is the only viable long term solution that would make any market redesign workable.”<sup>23</sup> LMP will not create incentives for transmission infrastructure development. This reality underscores the absolute necessity of preserving the State Contracts, which not only stabilize the market, but also signal the need for development.

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<sup>22</sup> Comments of the Bay Area Municipal Transmission Group, p. 14 and 16.

<sup>23</sup> Protest and Comments of NCPA, p.19.

**VIII. The CAISO's Stakeholder Process Has Not Been Successful in Addressing Unresolved Issues and the CAISO's Proposal Will Not Fix the Problem.**

In its response to the parties' comments, the CAISO asks the Commission to approve a stakeholder process to address the remaining unresolved issues while at the same time seeking approval of the CAISO's Amended MD02 Proposal. Thus, the CAISO requests that the Commission "(1) approve in its entirety the amended Comprehensive Market Design Proposal submitted in the July 22 Filing, and (2) approve the process proposed herein to address specified unresolved issues and the details of the market design, so that the CAISO can finalize the tariff language that the CAISO must file to implement the proposal."<sup>24</sup> These twin requests are incompatible, because if the market redesign proposal is approved first, then the stakeholder process will become superfluous. This concern is heightened by the failure of the CAISO's stakeholder processes to date to resolve, or even address, issues in a mutually satisfactory fashion. **Many of the design elements which the ISO asks the Commission to approve are themselves *unresolved issues* as far as many stakeholders are concerned.**

CERS agrees with the many parties who point out that the stakeholder process conducted by the CAISO has not adequately addressed the stakeholder concerns in the development of its Amended MD02 Proposal. The CAISO similarly recognizes that "[a] persistent criticism of the CAISO is that it fails to listen or respond to stakeholder feedback. Moreover, stakeholders often feel the CAISO hands them a fait accompli and moves through a stakeholder process for the sake of process. These concerns are

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<sup>24</sup> Motion for Leave to File Answer and Answer of the California Independent System Operator Corp., p. 5 (filed Sept. 18, 2003).

legitimate, and the CAISO must address them.”<sup>25</sup> CERS urges the Commission to assure that the CAISO addresses these concerns *before* approving a market redesign to which so many parties object, or alternatively condition any approval upon *a priori* resolution of the many concerns raised by stakeholders.

To improve the process, the CAISO proposes to establish an “External Energy Market Group” (“EEMG”) made up of representatives from each stakeholder group. CERS agrees that the CAISO and the stakeholders must come together, however, the details of the mission and duties of the EEMG and how it interacts with all of the stakeholders must be provided before CERS can offer its support. The CAISO also proposes a new set of “process options” that would apply to unresolved MD02 issues.<sup>26</sup> CAISO’s offer of process options at this juncture, after filing its proposal with the Commission and specifically asking that it be approved, does not offer sufficient assurance that concerns will be addressed. As noted, many features of the CAISO’s Amended MD02 Proposal for which the CAISO asks approval *now*, are in fact “unresolved issues.”

CERS urges the Commission to direct the CAISO to develop a clear set of definitive guidelines and rules for a stakeholder process in conjunction with and subject to a consensus among the affected stakeholders. **Stakeholders must be assured that the process in which to be heard is in fact *their* process as well as the CAISO’s.** This is

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<sup>25</sup> *Id.* at p. 20.

<sup>26</sup> *Id.* at pp. 21-22.

the only way that outstanding issues can be resolved in a manner that will increase the likelihood of success in market redesign.

## **IX. Conclusion**

The loud warning sounded by other parties urging preservation of the benefits of existing bilateral contracts, including the State Contracts, must be a priority for CAISO and the Commission in moving forward with the Amended MD02 proposal. CAISO recognizes that issues related to long-term contracts must be resolved “prior to implementing LMP.”<sup>27</sup> If the new market design is implemented without reasonably accommodating the State Contracts, 6,000 MW of long-term supply will be placed at-risk. Having to replace the energy associated with this amount of capacity through CAISO’s forward and real-time markets could destabilize the market in California and deprive California’s ratepayers of the State Contracts’ recognized benefits in terms of both market stability and encouraging future transmission and generation development. CERS endorses the comments of PG&E, NCPA and other parties urging the Commission to preserve of the bargained-for benefits of all long-term contracts.

The Amended MD02 Proposal is far from complete, and if implemented as proposed, could impose significant additional costs on California ratepayers. The backbone of the proposal, an integrated forward market featuring LMP, will not remove or address the most serious impediments to achieving a functionally competitive market: inadequate infrastructure and the lack of effective demand response programs.

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<sup>27</sup> CAISO Transmittal Letter, p. 20.

The many problems left unresolved by the Amended MD02 Proposal, coupled with the identified weaknesses of the California transmission grid and stressed state of the existing markets, suggests that the CAISO's proposed time frame for implementation of their proposal is unrealistic. As a condition of approving the CAISO Amended MD02 Proposal, CERS urges the Commission to impose three requirements on the CAISO: 1) the establishment of a stakeholder process developed by the market participants as well as the CAISO; 2) that all system design and software platforms contracted for by the CAISO be sufficiently flexible in design to allow for later, necessary, modifications; and 3) identification of an appropriate, well-defined, transition period which precedes implementation of the LMP integrated forward market. These steps will better ensure that the essential elements of the State Contracts are preserved and that the final market redesign accomplishes its objectives.

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(signature follows)

Dated: September 26, 2003

Respectfully submitted,

By: /s/ Paul Stein

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**Certificate of Service**

I hereby certify that I have served the foregoing document by first class mail or fax upon each party identified in the official service list compiled by the Secretary in this proceeding.

Dated at San Francisco, CA this 26th day of September 2003.

/s/ Paul Stein

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